SANITIZED DECS. – 03-106 SV, 03-107 SV, 03-108 SV, 03-109 SV, 03-109 SV, 03-110 SV, 03-111 SV, 03-112 SV, 03-113 SV, 03-114 SV, 03-115 SV, 03-116 U & 03-117 U – BY – GEORGE V. PIPER - SUBMITTED FOR DECISION ON BRIEFS – 11/05/03 – ISSUED – 02/05/04

SYNOPSIS

SEVERANCE TAX -- VALUATION OF PRODUCED GAS -- NO ADDITIONS FOR PURCHASERS' EXPENSES -- The value of natural gas at the point where title passes shall be measured by the gross proceeds received, less transportation to the point of sale, without adding back any sums deducted by purchasers for items incurred by purchasers in marketing said natural gas to others.

SEVERANCE TAX -- GROUP OR COMBINATION ACTING AS A UNIT -- Pursuant to W. Va. Code § 11-13A-5(a), joint ventures established and operated by Petitioners for the purpose of producing oil should have reported all gross proceeds as a separate reporting unit because the same are deemed to be a "group or combination acting as a unit and one person" as defined by W. Va. Code § 11-13A-2.

FINAL DECISION
ON THE LEGAL ISSUES

The Director of the Field Auditing Division of the Commissioner's Office issued a severance tax assessment against Petitioner 1. This assessment was for the period of January 1, 1999 through December 31, 2001, for tax, interest, through December 31, 2002, and no additions to tax.

Also, on December 11, 2002, the Director of the Division issued a severance tax assessment against Petitioner 2, under the provisions of Chapter 11, Articles 10 and 13A of the West Virginia Code, for the period of January 1, 2000 through December 31, 2001, for tax and interest, through December 31, 2002, and no additions to tax.

Also, on December 11, 2002, the Director of the Division issued a severance tax assessment against Petitioner 3, under the provisions of Chapter 11, Articles 10 and 13A of the West Virginia Code, for the period of January 1, 2000 through December 31, 2001, for tax, interest, updated through December 31, 2002, and no additions to tax.

Also, on December 11, 2002, the Director of the Division issued a purchasers' use tax assessment against Petitioner 3, under the provisions of Chapter 11, Articles 10 and 15A of the West Virginia Code, for the period of January 1, 2000 through September 30, 2002, for tax, interest, updated through December 31, 2002, and no additions to tax.

Also, on December 11, 2002, the Director of the Division issued a severance tax assessment against Petitioner 4, under the provisions of Chapter 11, Articles 10 and 13A of the West Virginia Code, for the period of January 1, 1999 through December 31, 2001, for tax, interest, through December 31, 2002, and no additions to tax.

Also, on December 11, 2002, the Director of the Division issued a purchasers' use tax assessment against Petitioner 4, under the provisions of Chapter 11, Articles 10 and 15A of the West Virginia Code, for the period of January 1, 2000 through September 30, 2002, for tax, interest, through December 31, 2002, and no additions to tax.

Also, on December 11, 2002, the Director of the Division issued a severance tax assessment against Petitioner 5, under the provisions of Chapter 11, Articles 10 and 13A of the West Virginia Code, for the period of January 1, 1999 through December 31, 1999, for tax, interest, through December 31, 2002, and no additions to tax.

Also, on December 11, 2002, the Director of the Division issued a severance tax assessment against Petitioner 6, under the provisions of Chapter 11, Articles 10 and 13A of the West Virginia Code, for the period of November 1, 1999 through December 31, 2000, for tax, interest, through December 31, 2002, and no additions to tax.

Also, on December 11, 2002, the Director of the Division issued a severance tax assessment against Petitioner 7, under the provisions of Chapter 11, Articles 10 and

13A of the West Virginia Code, for the period of January 1, 1999 through December 31, 2001, for tax, interest, through December 31, 2002, and no additions to tax.

Also, on December 11, 2002, the Director of the Division issued a severance tax assessment against Petitioner 8, under the provisions of Chapter 11, Articles 10 and 13A of the West Virginia Code, for the period of January 1, 1999 through December 31, 2001, for tax, interest, updated through December 31, 2002, and no additions to tax.

Also, on December 11, 2002, the Director of the Division issued a severance tax assessment against Petitioner 9, under the provisions of Chapter 11, Articles 10 and 13A of the West Virginia Code, for the period of January 1, 1999 through December 31, 2001, for tax, interest, updated through December 31, 2002, and no additions to tax.

Also, on December 11, 2002, the Director of the Division issued a severance tax assessment against Petitioner 10, under the provisions of Chapter 11, Articles 10 and 13A of the West Virginia Code, for the period of January 1, 1999 through December 31, 2001, for tax, interest, updated through December 31, 2002, and no additions to tax.

Written notices of all the assessments were served upon the Petitioners.

Thereafter, by hand delivery on February 7, 2003, the Petitioners timely filed with this tribunal, the West Virginia Office of Tax Appeals, petitions for reassessment. *See* W. Va. Code § 11-10A-8(1) [2002].

Subsequently, written notice of a hearing on the petitions was sent to the Petitioners and a hearing was held in accordance with the provisions of W. Va. Code § 11-10A-10.

FINDINGS OF FACT

1. Petitioner 2 is a limited partnership organized under the laws of the State of West Virginia.

2. Petitioner 3, an independent oil and natural gas producer, is the corporate general partner of Petitioner 2.

3. Each assessment joint venture, which exists to produce and sell oil and natural gas, was created by agreement between Petitioners, as operator of a particular oil or gas well, and one or more non-operating venture partners that are generally individuals or companies in the oil and gas industry (hereinafter, "the Agreements").

4. The oil and natural gas wells that are the subject of the Agreements are located in West Virginia.

5. Petitioners' gathering system, which consists of hundreds of miles of pipeline, delivers natural gas into the pipelines of the purchaser and/or marketer of the oil and natural gas.

6. Under natural gas purchase contracts with each of the joint ventures, the purchaser and marketer of the natural gas was either Company A, Company B or Company C.

7. The point of sale, that is, the point at which each joint venture relinquishes title to the natural gas to the purchaser under the natural gas purchase contracts, is the point where the gathering system intersects with the purchaser's pipeline.

8. Under the natural gas purchase contracts, immediately prior to the point of sale, the respective joint venture owns the natural gas and after the point of sale, the respective purchaser owns the natural gas.

9. As is typical in the oil and natural gas industry, the natural gas purchase contracts were entered into as a result of negotiations between the Petitioners, as producers and sellers of natural gas, with a prospective purchaser and marketer.

10. Generally, the ultimate price of all oil and natural gas is a function of the market, and is determined by an out-of-state mercantile exchange, a published index that changes with the market.

11. The base price to be paid under a particular oil or gas purchase contract is typically the out-of-state mercantile exchange's closing price for the month preceding the date of the contract; however, that price is subject to increases and decreases based upon the location of the oil and natural gas and upon various adjustments made by a particular marketer.

12. Because of the proximity of their natural gas wells to the market, the price received by the joint ventures reflects a premium, according to natural gas commodity prices, which are published as an index termed the "Appalachian Index."

13. Based upon quantity of oil and natural gas purchased, the term of the contract, and other economic factors, the ultimate price paid under the natural gas purchase contracts is a function of two components: (i) a negotiated percentage of the Appalachian Index; and (ii) purchaser adjustments representing many of the purchaser's costs associated with moving the natural gas through the pipelines to the ultimate end consumer.

14. In the context of the natural gas purchase contracts, which reflect the practice of the oil and natural gas industry generally, the purchaser's adjustments consist

of transportation fees, extraction fees, fuel retention fees, marketing fees, processing fees, gathering fees, and metering fees.

15. The purchaser's adjustments occur after the point of sale and do not represent the Petitioners' production costs.

16. To move the natural gas along its pipeline, each purchaser incurs a transportation fee that is passed along to the seller by virtue of the ultimate price for which the purchaser pays for the oil and gas, as reflected in the negotiated gas purchase contracts.

17. In the context of the oil and natural gas industry, transportation is the movement of gas across transmission facilities that are not designated by the Federal Energy Regulatory Commission ("FERC") as gathering lines.

18. As a result, according to industry practices, the transportation fee is treated as an expense of the purchaser because the transportation takes place after the purchaser takes title to the natural gas, and, thus, the fee is incurred after the point of sale.

19. So-called "extraction fees" are incurred by the purchaser to extract various hydrocarbons from the natural gas, after it has been purchased from the producer, but which fees are passed along to the producer by reducing the price for which the purchaser pays for the natural gas, as reflected in the natural gas purchase contracts.

20. Fuel retention fees are incurred by the purchaser and consist of costs of fuel retained to compress the natural gas to uniform, transportable pressures, after the point of sale.

21. In addition, fuel retention is also a method whereby the purchaser deducts a certain amount of natural gas from the amount it pays the producer in order to reimburse itself for <u>its own</u> meter discrepancies and line losses.

22. Marketing fees consist of various administrative fees, incurred by the purchaser after the point of sale, which reduce the price for the oil and natural gas that the purchaser pays to the producer.

23. Processing fees are costs incurred by the purchaser to remove impurities from the natural gas after the point of sale and also reduce the ultimate price that the purchaser pays the producer of the natural gas.

24. Gathering fees are fees charged by the purchaser to aggregate small amounts of natural gas it buys from the producers into a larger amount of natural gas on a pipeline.

25. Adjustments by the purchaser for its gathering fees represent the greatest amount of the purchaser's adjustments to the prices paid to the Petitioners.

26. Metering fees are charges incurred by the purchaser when its natural gas meter is read and are often passed along to the producer through reductions of the price paid for the natural gas.

27. The natural gas purchase contracts between Company A and Petitioner 2 state that the producer shall be responsible for any and all gathering and processing fees and fuel use, plus any other transportation costs incurred to deliver the natural gas to the delivery points.

28. The natural gas purchase contracts between Company A and Petitioner 2 also state that the price under the contract shall be inclusive of and deemed to

reimburse seller for severance, gathering, compression, and any other production-related services performed thereunder, and that any sales, usages or other taxes, assessments or fees (including gathering, compression or processing fees and/or shrinkage) that are levied on the purchaser shall be withheld from payment to the producer.

29. As negotiated and set forth in the natural gas purchase contracts, the purchaser's adjustments are deducted to yield the total payment due the producer, a practice that is accepted and prevalent in the oil and natural gas industry.

30. Each month, the joint ventures receive a "payment report" from each respective purchaser which reflects the purchaser's adjustments as provided in the natural gas purchase contracts.

31. Because a meter is located at each point of sale, Petitioners have the ability to and do independently verify the amount of natural gas listed in the payment reports.

32. The payment reports from Company 2 and Company 1 also include ''gross columns;'' which represent the net volume of natural gas produced multiplied by the unit price of the natural gas.

33. In order to internally count for and to remit to the respective investors their respective shares of the gross proceeds from the natural gas and oil produced under each joint venture, Petitioners prepared monthly work papers.

34. The internal workpapers are a management tool that is utilized by Petitioners for internal accounting purposes only and are based on and serve to summarize the data shown on the payment reports.

35. Despite the internal designation of the summary of the workpapers as an ‘‘invoice,’’ it is not sent to the purchasers or otherwise used externally and has no independent significance.

36. After so combining the information from the respective payment reports as the gross proceeds of sale of the natural gas and oil on each joint venture's severance tax return, Petitioners then deducted a standard fifteen percent (15%) for its cost of gathering and moving the natural gas to the point of sale.

37. As a result, the gross proceeds for their natural gas production shown on the Petitioners' severance tax returns do not include or otherwise reflect the various purchaser's adjustments made to determine the price they received for that production.

38. With regard to the assessment against Petitioner 9 that Petitioner was entitled to receive under its contract; however, it did not receive same because the other party, Company C, filed for bankruptcy.

39. Ultimately, Petitioner 9 received only a certain amount in February 2001, when Company B assumed Company C's contract. This amount was never reported for severance tax purposes and Petitioner 9 concedes that it owes same. The difference between the two figures should be deleted from the aforesaid assessment because said amount was never received.

40. With respect to the two (2) use tax assessments, the parties agreed at the hearing that the Tax Commissioner would not seek to tax payments for mowing and security services in the field, while Petitioners conceded liability for vehicle repairs and telephone services. The Petitioners' use tax assessments will be revised accordingly.

DISCUSSION

The primary issue to be decided is whether the Petitioners have shown that the tax auditor incorrectly determined the well-mouth value of their produced natural gas by adding various sums to the gross proceeds it received from the sale of said gas.

Severance taxes in West Virginia are governed by W. Va. Code § 11-13A-1, *et. seq.* Section three-a of Article 13A imposes the tax on the privilege of severing natural gas or oil and provides, in pertinent part, that:

> (a) Imposition of tax. – For the privilege of engaging or continuing within this state in the business of severing natural gas or oil for sale, profit or commercial use, there is hereby levied and shall be collected from every person exercising such privilege an annual privilege tax . . .
> (b) Rate and measure of tax. – The tax imposed in subsection (a) of this section shall be five percent of the gross value of the natural gas or oil produced, as shown by the gross proceeds derived from the sale thereof by the producer, except as otherwise provided in this article.

W. Va. Code § 11-13A-3a. (emphasis added)

The broader term, “natural resources,” is defined as “all forms of minerals including, but not limited to . . . natural gas, oil and natural gas liquids….” W. Va. Code § 11-13A-2(c)(8). The term “gross value” means “the market value of the natural resource product, in the immediate vicinity, where severed, determined after application of post production processing generally applied by the industry to obtain commercially marketable or usable natural products.”. . . .” W. Va. Code § 11-13A-2(c)(6).

The definitions further explain that the term “gross proceeds” means the value, whether in money or other property, actually proceeding from the sale or lease of tangible personal property, or from the sale or lease of tangible personal property, or from the rendering of services, without any deduction for the cost of property sold or leased or expenses of any kind.” W. Va. Code § 11-13A-2(b)(5) (emphasis added).

However, when it comes to the production of natural gas and oil, the general terms “gross value” and ‘‘gross proceeds’’ must be read in light of the special rule providing that “processed” or “processing” as applied to . . . oil and natural gas shall not include any conversion or refining process.” W. Va. Code § 11-13A-2(c)(9)(A). *See also* W. Va. Code § 11-13A-2(a) (providing that the definitions shall have their ascribed meanings “unless a different meaning is clearly required by the context in which the term is used, or by specific definition.”).

To this end, the statute further provides that “[a] taxpayer’s method of accounting under this article shall be the same as the taxpayer’s method of accounting for federal tax purposes.” W. Va. Code § 11-13A-7(c)(1). By way of sworn affidavit, Petitioners’ accountant testified that:

> In reporting its gross income from its share of the income from those natural gas wells, for federal and state income tax purposes, for the years 1999 through 2001, Petitioner 3 entered the same amount that represents its share of the production reported for those same wells for West Virginia severance tax purposes. (Petitioner’s Exhibit No. 6).

Moreover, for federal income tax purposes, gross income is defined to mean “all income from whatever source derived.”’ Internal Revenue Code § 61. Implicit in this definition of gross income is the understanding that a taxpayer is subject to income tax only on income that the taxpayer actually realizes. In all events, income clearly does not include expenses of another entity. <u>Comm’r v. Glenshaw Glass Co</u>.. 348 US 426 (1955) (holding that income is undeniable accession to wealth, clearly realized, over which taxpayer has complete dominion); <u>Helvering v. Horst</u>, 311 U.S. 112 (1940) (holding that realization of income, rather than acquisition of right to receive it, is a taxable event and is not deemed to occur until income is paid).

The governing severance tax statute also explains that “[f]or natural gas, gross value is the value of the natural gas at the wellhead immediately preceding transportation and transmission.” W. Va. Code § 11-13A-3a(c)(6)(G). Thus, the legislative regulations implementing the statute explain that “[i]n order to arrive at the well-mouth value of such severance and production, transportation or transmission expenses incurred by producers of natural gas <u>before its sale</u> shall be allowed as a deduction from the gross proceeds of the sale of such gas.” 110 Code of State Regulations Series 13A, § 4.8 (emphasis added).

That regulation further provides four alternative methods that may be employed by a taxpayer to determine the well-mouth value of the severance and production of natural gas that is not sold at the well-mouth. <u>Id</u>. The provision covering the alternative method chosen by the joint ventures reads as follows:

> 4.8.4. As an alternative to the methods presented at Subsections 4.8.4 [sic] through 4.8.3 supra, the well-mouth value of such severance and production of natural gas <u>not sold at the well-mouth</u> may be determined by a deduction of transportation and transmission costs in the amount of 15% of the gross proceeds of the natural gas severed and produced. This deduction shall be supported by a statement of the gross proceeds of sale of the natural gas severed and produced, and a computation of the deduction therefrom, and shall be subject to review and audit, and possible assessment or refund as a result of audit, by the Tax Department. The Tax Commissioner also reserves the right to disallow the application of this method of valuing the production of natural gas at the well-mouth when it can be established that a 15% transportation deduction does not accurately represent the well-mouth value of the gas severed, produced and sold.

110 Code of State Regulations Series 13A, § 4.8.4 (emphasis added).

During the periods here in question, the Petitioners reported and paid tax on their natural gas production for severance tax purposes based on the gross proceeds of sale they actually received, less the 15% adjustment to reflect the fact that their gas was not sold at the well-mouth.

At the hearing, an official of one of the primary purchasers, Company A, who was responsible for such matters, explained that the amounts listed as “gross payment” on the payment reports represented the value of the gas *it* resold to ultimate consumers and did *not* represent the price the Petitioners were entitled to receive from Company A for the gas.

Simply put, the well-mouth value of the natural gas severed by the Petitioners – that amount is the measure of the severance tax -- does not include qualitative and place-utility values *added* by the various processing and transportation services employed *by the purchasers* of such gas. Rather, it is precisely because of those costs that just-extracted, unprocessed natural gas is worth *less* at the well-mouth than at any point closer to the final consumer.

This finding is recognized in the provisions of the implementing regulations which give four alternative methods to determine the proper amount to *deduct from -- not add to* -- the proceeds of the first sale of gas to determine its well-mouth value, when that first sale does not occur at the well-mouth. 110 Code of State Regulations, Series 13A, § 4.8.

It is also manifested in the provisions of the governing statute, which expressly *excludes* from the gross value of natural gas “any conversion or refining process.” W. Va. Code § 11-13A-2(c)(9)(A).

Finally, that reality is also recognized by the statutory provision describing the measure or base of the severance tax as it applies to natural gas production, to-wit: “for natural gas, gross value is the value of the natural gas at the wellhead *immediately* *preceding transportation and transmission.*" W. Va. Code § 11-13A-2(c)(6)(G). (emphasis added)

Accordingly, it is determined that the severance tax assessments do incorrectly <u>add</u> back sums expensed by the <u>purchasers</u> of Petitioner's gas, thereby inflating the gross <u>proceeds</u> of sale over and above that actually <u>realized</u> by the Petitioners.

The second issue is whether Petitioners have shown that during the audit period they correctly reported all of the gross proceeds received from oil produced with others.

W. Va. Code § 11-13A-5 (Oil and gas operating unit) states as follows:

> (a) For purposes of the production of oil classification and the production of natural gas classification, as set forth in this article, multiple co-owners of oil or natural gas, in place, lessees thereof, or others being vested with title and ownership to part or all of the oil and gas, as personal property, immediately after its severance, extraction, reduction to possession and production (except royalty recipients in kind) shall be deemed to be a "group or combination acting as a unit" and one "person" as defined in section two [§ 11-13A-2] of this article, if not otherwise defined therein, whenever engaged in the producing of oil or natural gas through common use (by joint or separately executed contracts) of the same independent contract driller or operator's services; and notwithstanding provisions of private contracts for separate deposit of gross receipts in separate members' accounts or for members of such group or combination to take in kind any proportionate part of such natural resources.

The purpose of this statute is to make the operating unit one "person" for the purpose of administering the severance tax. In light of this statute, whether others who "co-produced" the gas may or may not have paid the tax is largely immaterial. The producer is the entity representing the entire venture in the eyes of the Commissioner for the administration of this tax. The explicit language of the statute even anticipates and addresses this very issue, when it states, "'. . . notwithstanding provisions of private contracts for separate deposit of gross receipts in separate members' accounts or for members of such group or combination to take in kind any proportionate part of such natural resources."' Regardless of where the royalties go, for severance tax purposes, the owners, producers, and anyone else with an interest are considered one "person." In this case, the correct entity assessed is in fact the Petitioners, as they are responsible co-producers for the units.

It should be noted that, although Petitioners argue that all severance taxes were paid by the parties and in two (2) cases were overpaid, the fact remains that a joint venture, as a statutory tax reporting unit, remains the responsible payor, and the Petitioners, as the managing producers, are the responsible parties.

Accordingly, it is also determined that Petitioners did not correctly report oil production derived from the joint ventures; however, credit will be allowed for the taxes which the Petitioners previously paid.

CONCLUSIONS OF LAW

Based upon all of the above it is **DETERMINED** that:

1. In a hearing before the West Virginia Office of Tax Appeals on a petition for reassessment, the burden of proof is upon the petitioner-taxpayer to show that the assessment is incorrect and contrary to law, in whole or in part. *See* W. Va. Code § 11-10A-10(e) [2002] and 121 C.S.R. 1, § 63.1 (Apr. 20, 2003).

2. Petitioners-taxpayers in this matter <u>have</u> carried the burden of proof with respect to the issue of whether the well-mouth value of Petitioners' produced natural gas should be calculated by <u>adding</u> various sums to their gross <u>proceeds</u> of sale for items which were expensed by the <u>purchasers</u> of said natural gas; these additions to gross proceeds should <u>not</u> have been made.

3. On the other hand, Petitioners have failed to carry the burden of proof with respect to their argument that Petitioners correctly reported their oil production as mere co-owners of same, rather than as joint ventures, in light of W. Va. Code § 11-13A-5(a)..

DIRECTIVES RESPECTING COMPUTATION OF THE AMOUNT OF TAX DUE

1. In accordance with 121 C.S.R. 1, § 73.1.1, the above shall constitute a statement of the opinion of the West Virginia Office of Tax Appeals determining the issues in the above-captioned matter;

2. The West Virginia Office of Tax Appeals is withholding entry of its decision for the purpose of requiring the parties to submit computations of the tax due and owing consistent with the opinions set forth above;

3. As stated above, the gross proceeds derived by the petitioners from the sale of their produced natural gas shall <u>not</u> include any of the sums expensed by the purchasers of said natural gas;

4. As stated above, the gross income derived from the sale of its produced oil shall remain taxable because the whole amount should have been reported as a joint ventures by the Petitioners, rather than just the amount which it ultimately received;

5. Within 30 days of service of this Final Decision on the Legal Issues, the parties shall meet in an attempt to reach an agreement with respect to the computation of tax due in accordance with the above-stated Division;

6. If the parties are unable to agree upon an amount of tax due, then in accordance with the provisions of 121 C.S.R. 1, § 73.2.1, and within 45 days of service of this Decision, either party may submit a computation of the amount of tax that it

believes is due, and serve its computation on the West Virginia Office of Tax Appeals and on the other party;

7. If only one party submits a computation of the amount of tax it believes is due, the Office of Tax Appeals shall proceed in accordance with the provisions of 121 C.S.R. 1, § 73.2.2;

8. If both parties submit a computation of the amount of tax they believe is due, either in accordance with the provisions of 121 C.S.R. 1, § 73.2.1 (where both parties file their computations simultaneously) or 121 C.S.R. 1, § 73.2.2 (where one party files its computation and the other party files its computation in response), the Office of Tax Appeals shall proceed in accordance with the provisions of 121 C.S.R. 1, § 73.2.3;

9. If, after the submission of computations of the amount of tax due by both parties, either party believes that an evidentiary hearing is necessary, within 10 days of receipt of the opposing party's computation, it shall submit a request for an evidentiary hearing, clearly and succinctly setting forth the grounds upon which its request is based, and describing the nature of any evidence that it intends to introduce.

Upon receipt of an agreed upon computation of tax due, pursuant to 121 C.S.R. 1, § 73.1.2, or upon resolution of any dispute in the computations of tax due submitted by the parties, pursuant to 121 C.S.R. 1, §§ 73.2.1 & 2, the West Virginia Office of Tax Appeals will enter its computation of tax due.